DOW THEORY LETTERS INC.

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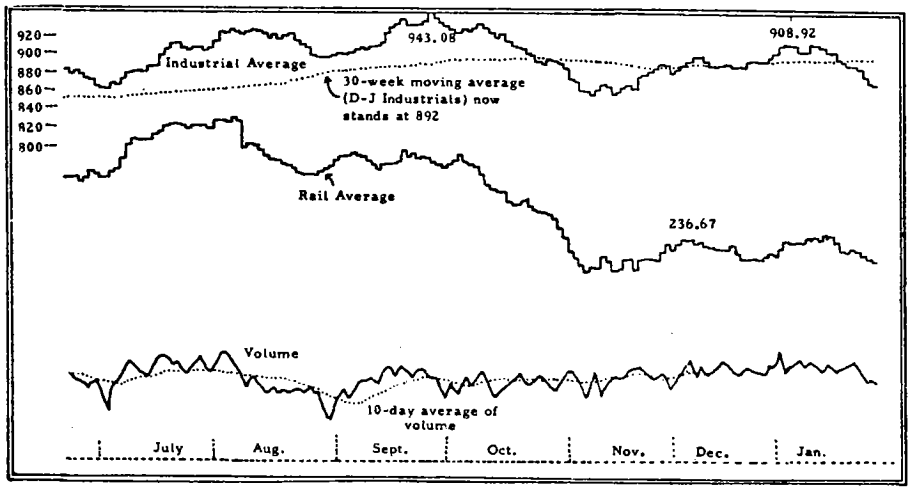
THE MARKET: There aren't many old-timers writing these days, particularly in the investment advisory field. Somehow, when receiving dozens of services here each week, I always give most attention to the few veterans, the men who have been watching the market and writing about it for a period of twenty or thirty years or more.

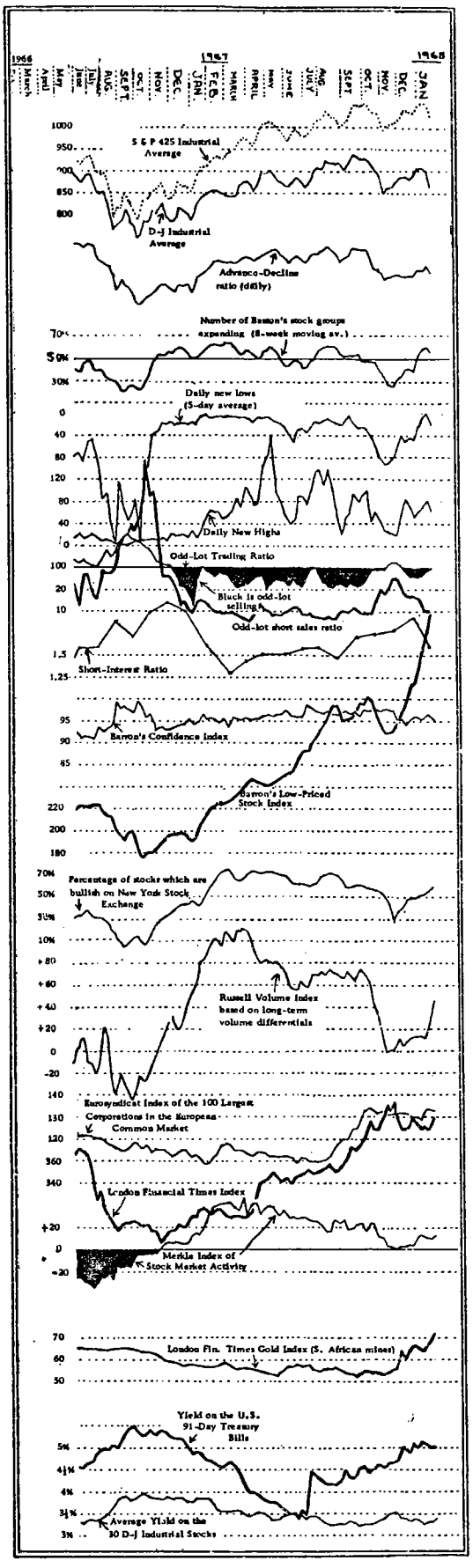
One man, George Schaefer (who started his service in 1948) writes this week: "Internally we are in shambles; internationally, we have already been adjudged a bankrupt. . . ." Later he notes, "The terrible situation that we face today is that the American economy is in horrendous trouble, and that there is no way in the world it can be deferred for too long or mitigated very much in an election year."

A second old timer, Paul Dysart (writing since 1933) notes in this week's report, "Never before have so many grave problems been polarized for solution in so short a time span. Add to them the uncertainties of a Presidential election year and you have a witch's cauldron boiling a poisonous potion of trouble and apparently insoluble problems."

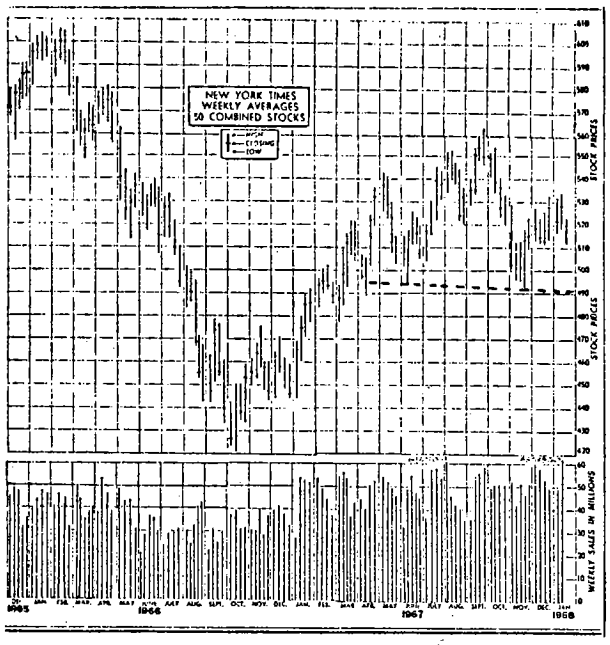
I have been warning subscribers that despite the speculation, we have been in a particularly treacherous and deceptive primary bear market since February, 1966. All the machinations, manipulations and powers of President Johnson and his Administration have been arrayed against the natural expression of this primary bear trend. Inflationary forces have been utilized to hold back the bear, an ocean of paper money has flooded the country, our gold stock has been squandered, a fantastically expensive war has been enlarged, a butter and guns policy has been adhered to. With it all, at no time since February, 1966, have the Industrial and Rail Averages been able jointly to better their 1966 highs. With it all the bear forces have held stubbornly intact.

William P. Hamilton, the great Dow Theorist, wrote that "Congress, the Federal Reserve and the Bank of England all working together cannot reverse the primary trend once it is set in motion." The primary trend is more powerful than the combined power of all the Central Banks of the world, and now that it is bearish (as it has been since early 1966) it will ultimately run to conclusion.



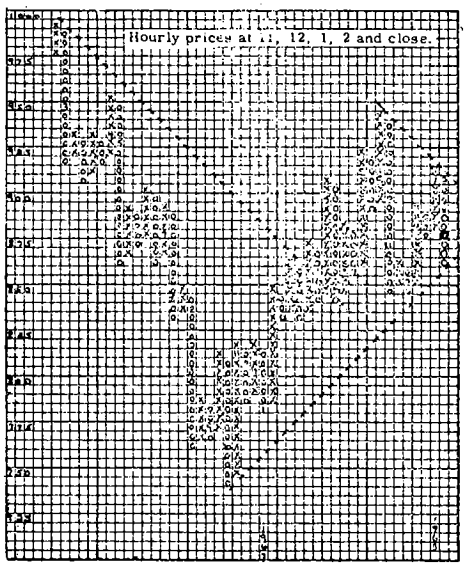

1966
1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily new lows (5-day average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fin. Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

The Dow Theory has been steadfast in its warning of a primary bear market in progress. I have repeatedly warned that no two bear markets start or progress in the same way. Some start with a downside bang, others take months to develop momentum. This ear market has been accompanied by some of the most fantastic specu-ation ever seen on Wall Street. Many worthless stocks have been bid up to absurd levels, even while the blue-chip Dow stocks have been sinking listlessly lower. Volume on the Amex only last week rose to record volume five days in succession. Massive amounts of "junk shares" have been unloaded on a frantic public, stocks which in many cases are selling at 50 to 100 times unseasoned earnings.



Meanwhile, patient, hard-headed investors are sitting with cash positions and gold and silver shares awaiting the inevitable appearance of the primary bear forces. When the party is over, clean-up time arrives. As a rule on Wall Street, the greater the speculative party (and this is particularly true during a bear market rally), the worse the hangover. It is probable that we are heading into the hangover period now.

Last week (see page 1 chart) the Industrial Average plunged below its 30-week moving average, which now stands at about 891. During the same period most of the leading gold shares rose to historic highs while Barron's Low-Priced Stock Index leaped to an all-time speculative peak of 400. To old-time observers it was a shocking and dangerous performance. It smacked of danger for Wall Street, the economy and the nation.



The New York Times Average of 50 stocks often shows the market picture more clearly than any other index. I include the weekly Times chart in this Letter, and here we note a giant head-and-shoulders formation with a base (or "neckline" of support) at the November lows comparable to the November low of 849.57 on the Dow. I suggest at readers watch the Dow 849.57 (850 to round it off) level with particular care during the weeks ahead. I feel that any penetration of 850 would send this market reeling sharply lower to test the 1966 lows (744.32 on the Dow).

On the point and figure charts the Dow turned bearish last week. Here we see a Chartcraft diagram (each box equals 5 points, X's indicate rallies, O's indicate declines, all reversals of 15 points or more are shown). I have marked the 880 box in solid black, since this is the point at which the Dow turned bearish on P & F. Note that at 880 the Dow broke below the column of X's at 885. The next point of interest is 855. If the Dow touches this it will rupture its rising (dashed) trendline. The final bearish point would be 845, which would represent a penetration of the double bottom set in Nov., 1967, at 850.

There are many discrepancies divergences and inconsistencies in this market. I believe that most of them have been caused by the almost unprecedented speculation in low-priced shares (mostly on the upside while the investment-grade issues went lower).

For instance, the Russell Volume Index rose to 49 this week, but this is an expression of upside speculation in the "junk" issues, and I feel that this Index should be read with caution at this time. While the Index measures all volume of trading, I do not like action wherein the low-priced shares rise (as in 1966) while the better-grade shares slide.

I will repeat that one cannot, during a primary bear market, read the indicators with anything like the certainty with which one can read them during a bull market. This is particularly true during the deceptive second phase of a bear market (the phase we are now in). For example, with the almost record total of shorts now listed on the N.Y.S.E., this market should be as firm as a rock on the downside. It is not, and thus the short interest (like many other leading indicators) is probably in for a period in which it will be discredited.

In conclusion, there is no method of mechanical analysis which will displace a seasoned "feel" for the trend of the market. As e sage once noted, "the art of Wall Street analysis is knowing when to throw out what indicator at what given time."

1968: Last week the remnants of the British Empire were finally dismembered. Britain is to bring her troops back from the Far East, she is to pull out of territory which has been guarded from the time of Rudyard Kipling. She is to abandon her naval carrier

power, and as a final gesture, the billion dollar contract to the U.S. for F-111 fighters was cancelled.

It is too bad that President Johnson has learned nothing from the demise of Britain as a world power. But it is obvious that he did not. In his January 17 State of the Union speech, LBJ talked about this nation as if we were nothing but power and might, he glossed over or avoided all talk of serious trouble, he threw in the full porkbarrel portion of Great Society spending plans for 1968, and he "talked" about defending the dollar while removing the last vestiges of gold behind our currency. It was a pathetic, soft-soaping, talk-in-cheek, political speech, calculated to make people believe that the Executive had everything well in hand. If only Congress would listen to me, said LBJ, everything would be perfect. We can do it, he repeated on several occasions, if only we have the will.

But will without comprehension is useless, and it struck this observer that LBJ's speech showed no trace of comprehension regarding the problems of the dollar. Basically, the speech can be summed up in a single sentence: more inflation, more spending, and a fully paper (fiat) dollar without the discipline of gold. There was no mention of the dollar's defense, no talk of restricting the money supply, no talk of higher interest rates, no plan for limiting or halting the wage-price spiral. To suggest that this constitutes a defense of the dollar is the sheerest type of hokum and political hypocracy.

And what about the Far East, what about the British pullout from Malaysia, Singapore and the Persian Gulf? Obviously, the U.S. will have to move in here, thereby incurring new expenses on top of the current preposterous Vietnam bills. What about foreigners holding fiat dollars with their $30 billion total of foreign claims against around $10 billion in available U.S. gold? How long will our foreign creditors hold off, how long will they continue to hold paper dollars which are depreciating when, in fact, they could turn those dollars in for gold and then buy hard currencies such as Swiss francs or German marks? These are the questions which LBJ should be discussing or at least thinking about. These are the questions the market is thinking about, and they are the questions which will have to be answered.

NOTES AND QUOTES: Latest tabulations show that there are now 24 million stockholders in the U.S., up sharply from the 20 million of a few years ago. In December new margin accounts jumped 35,000 to a record total of 840,000 margin accounts. Customer debt was up $220 million to a record $6.3 billion borrowed against shares held.

In view of the above, I thought that Reserve Board Chairman McChesney Martin's appearance before a House Ways and Means Committee last week was interesting. Asked about the record volume, Martin gave a few reasons, one of which was "Every elevatorman in the country and just about every other individual has gotten the idea that the way to get rich is not to earn a salary but to get into the stock market."

* * * *

Appearing before the same Committee, here is what Gardner Ackley (President's Council of Economic Advisors) predicted if the Johnson Surtax is not passed, "……we would risk imbalance, overheating, financial distress, acceleration of the price-wage spiral and deterioration in our balance of payments." Evidently, this is what we can expect, then, because the chance of passing the surtax is slim and getting slimmer.

* * * *

A new booklet entitled "Gold Mining Shares" by Robert A. Gilbert offers tabulations based on gold going to $70 per ounce. This is what the following stocks would earn at $70 gold: Of the South Africans President Steyn would earn $1.89, Free State Geduld would earn $4.90, Western Deep $4.40, President Brand $2.70. In Canada Dome would earn $5.54 in Canadian dollars. In the U.S. Homestake would earn $12.40. These figures do not take into consideration possible additional taxes which might be levied against the companies, particularly in S. Africa where the government has an anti-inflation policy. However, figuring say 12 to 15 times earnings on these shares it is easy to see where President Steyn could quadruple at $70 gold, President Brand might double, Free State might almost triple, and Homestake could easily double. This, then is the type of leverage one might figure on if the price of gold is doubled.

WHAT WOULD EASE THE PRESSURE ON GOLD? Probing through the official smokescreen hanging over the gold picture, I have listed a few of the major "hopes" of the anti-gold forces together with my comments. I suggest that subscribers study these comments, keeping in mind my thoughts in the last Letter to the effect that the gold shares were holding up remarkably well in the face of a renewal of anti-gold propaganda barrage.

(1) The Vietnam war is the single biggest "hole" in the balance-of-payments dam. If the war ended, it would help the dollar and hurt gold shares. I outlined in the last Letter my reasoning for doubting any near-term ending of the War. I thought that the President's comments on Vietnam during his State of the Union speech added nothing new, continued the hard line, smacked of extreme stubborness, and provided few if any new hopes for any early termination of the war.

(2) The 10% surtax bill could be anti-inflationary (although that is very debatable), and it could bring more money into Treasury coffers, thereby cutting the deficit (this is debatable, too since a tax rise would cut into corporate profits). At

any rate, the chances of the tax bill passing after LBJ's grandiose State of the Union spending plans are slim indeed. The House ways and Means Committee (through which the belt must start) has practically written off a surtax, and, the Committee gave the bill scant attention when it arrived in Committee last week. The Committee generally took LBJ's speech very unfavorably, as austerity on the domestic front was an announced prerequisite required by the Committee even before consideration of a surtax.

t seems to me that LBJ 's tactic is "everything as before," and when trouble arrives all will be blamed on the non-cooperation of Congress. If he was really serious about wanting a surtax, LBJ would have presented the type of spending program which the Ways and Means Committee demanded (which meant much more austerity on the domestic front).

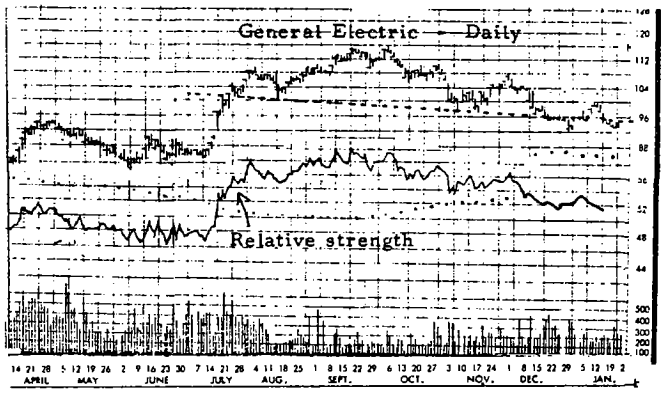
(3) A curtailment of domestic spending, and a shift to a real war economy would help our balance-of-payments and be adverse for gold shares. There is not a hint of this trend in anything coming out of Washington. The State of the Union speech was breathtaking in that it too did not even hint of any austerity intentions.

(4) Confidence in the dollar would increase if restrictions against the dollar and dollar-exchange were easing. But the converse is true. The more controls the Administration places against foreign investment, foreign money flows, foreign investments, the less confidence in the dollar. The trend towards dollar restrictions is now quickening. It can only scare foreign holders of dollars. The more restrictions, the more foreigners want "out". Out means a switch from dollars to gold. As Eliot Janeway stated in his January 17 Service, "....the more effective the new emergency program looks like it may become, the more likely it is to persuade or force foreign dollar holders to cash in some of the dollars they already have."

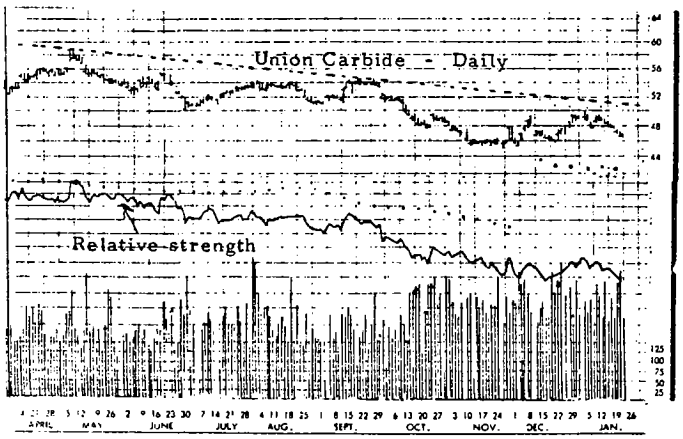
Perhaps the foregoing section explains why the gold shares have held well in the face of the latest blast of official talk and propaganda. A day before the State of the Union speech, the four major listed golds (American South African, Dome, Campbell Red Lake and Homestake) all leaped to historic highs. The Index of South African gold shares (see page 1 chart) is now at its highest point since mid-1965, with many individual issues (i.e., President Brand, Western Deep, Blyvoors, President Steyn) near their highest level in a few years.

As a final note, I suggest keeping eyes glued to the bond market. This is the sensitive index which will measure the chances of the war ending and the chances of a passage of the surtax. Already, the bellwether $4\frac{1}{4}$'s Treasury bonds of 1987-92 (having rallied from an historic low of 79 to the recent high of 86) have broken back in to the low 84 area. The supplementals being built into the economy are going to be whopping, to say nothing of the probable $5 billion war extra. If trends go along as I expect, the bond market could hit new lows during this Spring or Summer.

STOCKS: Many neophyte observers pooh-poohed the early 1968 weakness in the Dow stocks. Now that the "big guns" have led the whole market down, the skeptics are learning that the rest of the market cannot withstand a persistent trend in the 30 giant Dow components.



There is no question about it; the Dow stocks look weak, and I have picked at random the daily charts of two representative Dow issues for illustration. (Charts courtesy of Traders Research, 101 Cherry St., Alton, Ill. 62003). General Electric has traced out a clear head-and-shoulders top, then broke below its major support level (dashed line) in the 94-96 area. Relative strength in GE topped out in September and has been heading down ever since. Union Carbide has been tracing a series of descending peaks since October, 1965, with the weakness becoming particularly apparent in 1967 and 1968. At the current 46, the stock is within 4 points of its 1962 low. Relative strength in Carbide has been poor all year. At least half of the Dow stocks are acting as poorly as GE and Carbide, and in this writers opinion, the clear implication is that something is wrong.



LATE NOTES: As this is written, the Korean "ship-stealing" incident is in its second day. No one can know the full meaning of this direct confrontation with the U.S. by North Korea. My own guess is that Korea is "testing" U.S. resolve. North Korea probably wants to know how far the U.S. will go towards a second front, in view of the pressing problems in Vietnam. She wonders if the U.S. will commit new land troops to Korea and whether this latest pressure will set off a general "Let's get out of Asia before it's too late" cry in America. Anything can happen when the primary trend is down, and during a bear market the resolution of problems somehow never seems to work out too happily.